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In the Supreme Court of the United States

OCTOBER TERM, 1957

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

P. G. LAKE, INC.

FRANK SCOFIELD, FORMER COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

DENNIS M. O'CONNOR, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WM. FLEMING, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN WRATHER, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

W. F. WEED, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE PETITIONERS

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1. The correctness of our position that taxpayers' oil (or sulphur) payment assignments were assign-

ments of future income, and therefore not entitled to the preferential capital gain treatment accorded by Section 117, is evidenced by the fact that none of the taxpayers even attempts to offer a complete answer to the argument in our main brief (pp. 37–48) based on decisions of this Court relating to oil interests. All of the taxpayers dispute one part of that argument (pp. 37–41) by contending (or assuming) that their oil payment assignments were conveyances of depletable economic interests in the oil in place (*Fleming-Lake* Br. 21–31, 47, 55; *O'Connor* Br. 24, fn. 24, 35; *Wrather* Br. 6; *Wood* Br. 9–10), labelled in one brief as "the sale in bulk of barrels of oil in place" (*O'Connor* Br. 19) and in another brief as conveyances of "present interests in the properties" (*Fleming-Lake* Br. 27, 30, 47, 56). But the fact that a transaction may convey a present interest in property constituting a depletable interest is immaterial, as this Court specifically held in *Burnet* v. *Harmel*, 287 U. S. 103. The oil payment rights which taxpayers created and assigned were not the same type of property interest as the leasehold and royalty interests they owned. Thus, as we argued in our main brief (pp. 42–48), the consideration received for their assignments was, like a lease bonus, "payment in advance for oil and gas to be extracted" (*Herring* v. *Commissioner*, 293 U. S. 322, 324) and therefore taxable as ordinary income subject to depletion, just like a lease bonus. The taxpayers' contention that oil in place is both "tree" and "fruit" (*O'Connor* Br. 17–21; *Fleming-Lake* Br. 30–31; *Wrather* Br. 8) amounts to a contention that the oil is a capital asset,

and this Court plainly rejected that contention in the lease-transfer cases, beginning with the *Harmel* decision. Indeed, it is precisely because taxpayers' oil payment assignments were no more than sales of oil (as contrasted with sales of their oil interests as such) that the consideration received for their assignments is taxable as ordinary income subject to depletion rather than as capital gain.

2. Taxpayer's arguments that their oil payment transactions come within the spirit and purpose of Section 117 (*Fleming-Lake* Br. 48–55; *O'Connor* Br. 14–15; *Wrather* Br. 9, 11) are wholly without merit.

Taxpayers' briefs contain repeated references to other types of transactions, especially transfers of an owner's entire oil interest as such. The distinction between that type of transfer and a transaction which conveys less than the transferor's entire interest (or an undivided portion thereof) was drawn in the lease transfer cases and is fully applicable here. The whole theory of the distinction, never expressly enunciated but implicitly reflected in *Anderson* v. *Helvering*, 310 U. S. 404, 408, is that it is only when the owner of an oil interest sells his entire interest (or an undivided portion thereof), thereby severing his connection with the income derived from the production of oil and losing the depletion deduction through which he would otherwise recover his capital investment, that he converts the form of his capital investment, which he can thereafter recover only through subtraction of the basis of the transferred interest from the amount realized from its sale.

Taxpayers ignore this fundamental distinction, even to the extent of stating (see *O'Connor* Br. 6) that "If the purchaser of a carved out oil payment has purchased a capital asset, as he clearly has, the seller must have sold one." That statement is of course incorrect. An oil and gas lease is also a potential capital asset in the hands of the transferee but under the decisions of this Court the execution or so-called sale of a lease is not a sale of property within the purview of Section 117 when the transferor retains some other type of depletable interest, such as a royalty interest.

The mere fact that Congress intended Section 117 to apply to the sale of "mineral properties" (*O'Connor* Br. 14) affords no basis for applying the statute to a type of transaction which merely accelerates the receipt of future ordinary income from production (and the depletion deduction attributable thereto).* The taxpayers' surprising reliance upon the *Harmel* decision (*supra*) for an argument distinguishing between a single transaction and time-consuming operations resulting in daily sales (*O'Connor* Br. 14–16) ignores the fact that *Harmel* involved but one transaction, the execution of a lease, and held that the lump-sum consideration received for the lease (not just the retained future royalty payments) was taxable as ordinary income subject to depletion rather than as capital gain. The *Harmel* decision itself, as well as the subsequent lease-transfer decisions of this Court (see our main brief, pp. 42–48), furnishes a complete answer to the question posed by taxpayers (*O'Connor* Br. 23) as to whether Congress intended to deny capital-gain treatment to the proceeds received for oil payment rights when the transferor retains an interest in future production instead of selling his entire oil interest as such.

3. Taxpayers assert, however, that administrative practice and judicial precedents prior to 1946 require the conclusion that Congress has, in effect, given im-

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*The term "mineral property" is defined in the regulations as "the mineral deposit [meaning "minerals in place"], the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction." See Treasury Regulations 111, Section 29.23 (m)-1 (b) and (c).

plied approval to such capital gain treatment (*Fleming Lake* Br. 40–46; *O'Connor* Br. 28–30; *Wrather* Br. 11–12). Not one published, pre-1946 administrative ruling specifically relating to the taxation of carved-out oil payment rights is cited. For judicial precedent, three decisions prior to 1946 are cited, two of them (*Ortiz Oil Co.* v. *Commissioner*, 102 F. 2d 508 (C. A. 5th); *Majestic Oil Corp.* v. *Commissioner*, 42 B.T.A. 659), involving situations which may come within a possible exception to our position here (see fn. 19, p. 39 of our main brief), being cases where an oil payment right was given to obtain money to be used for the development of oil properties. The third case (*Nail* v. *Commissioner*, 27 B.T.A. 33), decided in 1932, seems in point, although the facts are not entirely clear.

Administrative practice and judicial decisions can be deemed to have been "ratified" by Congress only if they had crystallized into a clearly formulated rule which was unmistakably brought to the attention of the legislators when they reenacted the underlying statute. See, *e. g.*, *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455; *United States* v. *Leslie Salt Co.*, 350 U. S. 383. Section 117, first enacted in 1921, has been in continuous effect in substantially the same language, but Congress certainly cannot be deemed to have been aware of, much less to have given approval to, a pre-1946 administrative practice relating to carved-out oil payment rights which was not reflected in any published ruling. Moreover, administrative practice "gives way before changes in the prior rule or practice through exercise by the administrative agency

of its continuing rule-making power." *Helvering v. Reynolds*, 313 U. S. 428, 432.

Whatever may have been the Commissioner's pre-1946 view regarding assignments of carved-out oil payment rights, he made no published ruling on the subject until 1946, shortly after assignments of carved-out oil payment rights began to have "widespread usage" in the oil industry "as a device to turn ordinary income into capital gain" (32 Taxes, Tax Magazine 494, 496). Then, noting that the assignments were usually of short duration, it was ruled that assignments of so-called "short-lived in-oil payment rights" are assignments of future income (as distinguished from sales of property under Section 117); a decision regarding assignments of long-lived oil payment rights was specifically reserved, the ruling stating that "No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved." See G. C. M. 24849, (1946–1 Cum. Bull. 66, 69), printed in the *Fleming-Lake* brief at pages 117–124. In 1950, when advice was requested as to the phrase "short-lived in-oil payment rights" as used in G. C. M. 24849, the Commissioner, stating that it had been concluded that there was no legal or practical basis for distinguishing between short-lived and long-lived oil payment rights, ruled that the transfer of any carved-out oil payment right (not pledged for development) which extends over a period less than the depletable life of the property interest from which it is carved is an assignment of future income. See I. T. 4003

(1950-1 Cum. Bull. 10), printed in the *Fleming-Lake* brief at pages 125-126. If Congress has approved any administrative practice or view, it is the one reflected in the published rulings beginning in 1946. Cf. *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90.

4. Contrary to the implication contained in the *Fleming-Lake* brief (pp. 40, 45–46), the Commissioner is not here attempting to give "retroactive effect" to a "change in position." The earliest oil payment assignment involved here was made on December 24, 1947, which was after taxpayers had been put on notice, not only by the lease-transfer decisions of this Court but by G. C. M. 24849, that the consideration received for the assignment of any carved-out oil payment right might be held to be an assignment of future income. Plainly, the Commissioner's reservation in G. C. M. 24849 of a ruling as to assignments of long-lived oil payment rights (*supra*, p. 6) cannot be treated as if he had in fact affirmatively ruled that such assignments were to be accorded capital-gain treatment.

5. The argument that the Commissioner's position results in two depletion allowances on the same income (*Fleming-Lake* Br. 55–59) is erroneous. As already pointed out, the consideration received for an oil payment assignment by the owner of a leasehold or royalty interest is, like a lease bonus, payment in advance for oil to be extracted. It is therefore depletable by the assignor and, as in the case of a lease bonus (see Treasury Regulations 111, Section 29.23 (m)-1 (f)), the amount thereof may not be included in the assignee's base for percentage depletion pur-

poses (assuming that the assignee of a carved-out oil payment right receives a depletable economic interest in the oil in place). It follows that the assignee is entitled to percentage depletion on no more than the excess of the amount of the oil payments received over the amount of the consideration paid to the assignor (see our main brief, fn. 17, p. 37).

As a practical matter, the assignee will only rarely be entitled to take percentage depletion, since cost depletion (as in these cases) will almost always be higher than percentage depletion and the statute requires cost depletion where that is true. See Section 114 (b) (3) of the 1939 Code (26 U. S. C. 1952 ed., Section 114). Thus, the taxpayers' assignees will exclude, from their gross income received in connection with their oil payment rights, the total amount paid to the taxpayers for those rights. But to call this exclusion of cost a "depletion allowance" is misleading; for such cost would be tax-free irrespective of whether there existed a special oil depletion deduction and, indeed, irrespective of whether the oil payment rights even constituted a depletable economic interest. A "depletion allowance" of this nature is nothing more than a tax-free recovery of capital and is available to any transferee, not merely the assignee of an oil interest. See Sections 111 (a) and 113 (a) of the Code (26 U. S. C. 1952 ed., Sections 111 and 113).

Accordingly, aside from the fact that the Commissioner's position does not result in a double depletion allowance on the same income, the question of depletion as to the assignee is largely academic. The controlling considerations are that, regardless of

whether the assignee receives a depletable interest, the consideration received by the assignor for the oil payment assignment is depletable by the assignor as representing anticipatory oil proceeds (whether treated as a sale of oil or of a mere contractual right to receive future oil proceeds), the depletion deduction compensates the assignor for whatever loss of capital investment is occasioned by the oil payment assignment, and as to the assignor the transaction is only an assignment of future income.

It is respectfully submitted that the judgments in all five cases should be reversed.

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